Basic Annuity Basics

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Annuity Defined

annuity (*n.*) a specified income payable at stated intervals for a fixed or a contingent period, often for the recipient's life, in consideration of a stipulated premium paid either in prior installment payments or in a single payment.

Two basic types of annuities

Immediate annuity – income stream begins immediately upon payment of the first premium

Deferred annuity – income stream begins later (or not at all, at the owner's discretion)

Three basic types of deferred annuities

Fixed annuities

Fixed index annuities (sometimes erroneously called “equity index annuities”)

Variable annuities

Fixed deferred traditional annuities

- Principal guaranteed by the insurer
- Minimum interest rate guaranteed
- Current interest rate determined by company board of directors
- Low risk instrument
- General obligation of the insurer*

*subject to claims of the insurer's creditors

Fixed deferred index annuities

- Partial or whole principal guaranteed by the insurer
- A minimum interest rate may be guaranteed
- Current interest rate determined by a market index
- Generally more illiquid than a traditional fixed annuity
- General obligation of the insurer*

*subject to claims of the insurer's creditors

Variable Annuities

Market based investment without guarantees*

A security (must be sold by prospectus)

Agents must have both FINRA
and state insurance licensing

NOT a general obligation of the insurer

*certain variable annuities offer income guarantees at an additional cost;
read the prospectus carefully for details on these income guarantees

Things common to all annuities

Current income is tax deferred

Issued by life insurance companies

Provide “income you cannot outlive” provisions (“annuitization”)

Treated similar to IRA’s for tax purposes (10% early withdrawal penalties on interest if withdrawn before age 59 ½)

How traditional fixed deferred annuities work

Client purchases annuity with either a lump sum or series of payments

Current interest is credited (usually daily)

Client may take withdrawals from the annuity (usually 10-15% annually) without penalty

Penalties are assessed for exceeding the “free out” amount

How traditional fixed deferred annuities work

Principal is guaranteed

A minimum return (2-3%) is guaranteed

Interest crediting methods differ among products

Some are CD-like annuities, taken for a fixed term of years (usually illiquid)

How fixed deferred index annuities work

Penalty period may last from 5-20 years

Principal may be only partially guaranteed
(a common design is “3% on 90% of the money”)

Costs are higher and more complex than
for traditional fixed deferred annuities

Penalties are assessed for exceeding the
“free out” amount (if there is a free out provision)

How fixed deferred index annuities work

Utilizing the “free out” amount usually destroys any index return, making this instrument a poor choice for liquidity

Multiple crediting methods – annual reset, point to point, high water mark, any of which may include monthly averaging

In addition to surrender charges, additional costs generally apply

Practice applications

- Long term investing where liquidity is a minor factor
- As part of the bond component in an asset allocation program
- For a risk averse client who wants an opportunity for higher returns in a low interest rate environment

Suitability "Red Flags" for FIA's

- Putting most or all of a client's money in an FIA
- "Free out" portion of the index annuity normally loses the index gain if withdrawn, making it a poor choice to meet liquidity needs
- Unreasonably long surrender periods or liquidity requirements (e.g., require annuitization)

How variable annuities work

Is a security

Money invested in
market based “subaccounts”

Has more risk than a fixed annuity

Surrender charges similar to fixed annuities

How variable annuities work

Risks may be managed by purchasing income guarantees

Features a death benefit that may pay more than the annuity’s market value

Generally will outperform fixed annuities over long periods of time

Practice applications for variable annuities

Excellent alternative to non-deductible IRA's

Better long term choice than a fixed annuity

Can provide higher income for a client
who has not done a good job of saving

Good choice for wealth transfer
for an uninsurable client

Suitability issues for variable annuities

Can (and probably will!) lose value at some point, making it unsuitable for a risk averse client

Is expensive, making it unsuitable for a client investing solely in low risk subaccounts (fixed annuity would be a better choice)

“Annuitization”

Act of converting a deferred annuity
to an income stream of some kind
is called “annuitizing”

Immediate annuities
are “annuitized” at issue

“Buying a pension”

Practice applications for annuitization

Use the exclusion ratio for:

- Reducing or eliminating social security taxation
- Lowering taxable income to allow for Roth IRA conversions
- Funding life insurance premiums for tax favored wealth transfer

Taxation of Annuity Payments

Exclusion ratio

$$\text{Exclusion ratio} = \frac{\text{Investment in the contract}}{\text{Expected return}}$$

Taxation of Annuity Payments

Ten year certain payout

$100,000 investment

$1,077 monthly payout for 120 months

(total payments, $129,240)

Taxation of Annuity Payments

$$\frac{100{,}000}{129{,}240} = 77.4\%$$

Taxation of Annuity Payments

Tax free return of principal	1,077 x .774 = 834
Taxable gain	1,077 – 834 = 243

Examples of Annuity Payouts

$100,000 annuity, two spouses, age 60

Life only	$ 789
Life only with 10 year certain	737
Joint Life and 50% survivor	708
Joint life and 100% survivor	664
Joint life and 50 survivor- 10 year certain	698
Joint life and 100% survivor- 10 year certain	663
5 year certain	1,802
10 year certain	1,077

Alternatives to Annuitization

- Systematic withdrawals
- Commutation
- Split funded annuities

Systematic withdrawals

- Most deferred annuities offer “free out” provisions, amounts that may be withdrawn free of surrender charges
- Typically 10%
- May not be immediately available
- May be cumulative

Advantages of Systematic Withdrawal Income Strategy

Keeps options open

Credited rate theoretically rises in some relation to inflation

Maintains principal balance for heirs

Disadvantages of Systematic Withdrawal Income Strategy

Interest on pre-59½ withdrawals subject to 10% penalty

Loss of favorable exclusion ratio taxation

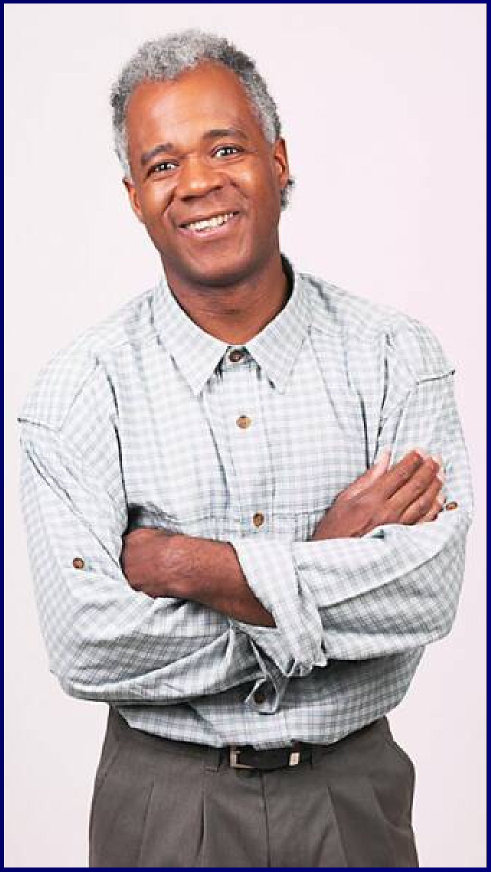
May run out of money!

Taxation of Annuity Withdrawals

Last in, first out

Must exhaust all the interest (taxable) before getting to principal (tax free)

Planning Technique Systematic Withdrawals



Jerry, age 50

Has $500,000 to invest in annuities

Wants flexibility between now and age 59 1/2

Planning Technique Systematic Withdrawals

Option 1 – Put $500,000 in one annuity

Age 55 – will have $500,000 principal, with $169,000 of taxable gain

Must remove $169,000 to get at any tax or penalty free money

Planning Technique
Systematic Withdrawals

Option 2 – Put $100,000 in five annuities

Age 55 – will have $500,000 principal, with $33,800 of taxable gain in each annuity

Must remove only $33,800 to get at tax and penalty free money

Split Funded Annuity

- Splits annuity premium into two separate annuities, one immediate, one deferred
- Conserves principal
- Maintains flexibility
- Enjoys tax advantages

How a Split Funded Annuity Works

Premium
$100,000

Immediate Annuity
$22,079.46

Deferred Annuity
$77,920.54

Grows back to $100,000
@5%

$5099.80 guaranteed annual income
paid for five years, of which
$4415.11 is tax free
$684.69 is taxable

Case Study : Bob and Nancy

Ordinary Income	15,000
Tax Free Interest	12,000
1/2 Social Security	10,000
Modified AGI	**37,000**

$5,000 over the tax free limit, making 50% of Social Security benefits taxable

Solution – Sell muni bonds and buy an immediate annuity

$250,000 muni bond proceeds which were paying 4.8%, generating $12,000 in tax free interest

10 year certain, life thereafter annuity with 25% exclusion ratio

Result – $3000 in includable income, $9,000 in tax free return of principal

Case Study: Bob and Nancy

Ordinary Income	15,000
Annuity interest	3,000
1/2 Social Security	10,000
Modified AGI	**28,000**

Social Security benefits are now tax free

Case Study: Susan, age 71

Has $75,000 invested in common stock

Wishes to pass to her two grandchildren

Case Study: Susan, age 71

Purchase $75,000 immediate annuity paying $5000 annually

Purchase $200,000 life insurance, naming grandchildren (or trust) as beneficiary

Case Study: Susan, age 71

Result – more than twice as much wealth passed, tax free

Four kinds of money

1. Money you need immediately
2. Money you'll need in a couple years
3. Money you'll need in several years
4. Money you'll never need

Typical suitable instruments for each type of money

1. Cash, savings or checking, money market accounts
2. Short term bonds, CD's
3. Stocks, equity mutual funds, annuities
4. Life insurance, annuities

What every client wants

- Guaranteed principal
- Tax free
- Completely liquid
- Guaranteed 15% (or greater!) return

The CLU Pledge

In all my professional relationships, I pledge myself to the following rule of ethical conduct:

I shall, in light of all conditions surrounding those I serve, which I shall make every conscientious effort to ascertain and understand, render that service which in the same circumstances I would apply to myself.

Summary

The key to a suitable annuity sale
is the fact finder (know your customer!)

ALWAYS consider liquidity needs

Is there a better solution?

Do the right thing!